BEFORE THE PUBLIC SERVICE COMMISSION
OF UTAH

In the Matter of the Petition of QWEST CORPORATION for Declaratory Ruling or, in the Alternative, for Approval of the Sale of the Utah Assets of Qwest Dex, Inc.	:	Docket No. 02-049-76

DIRECT TESTIMONY

OF

MICHAEL BROSCH

ON BEHALF OF THE COMMITTEE OF CONSUMER SERVICES

28 JANUARY 2003

Non-Confidential Version

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PREPARED TESTIMONY OF
MICHAEL L. BROSCH

Introduction and Qualifications

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Utah Committee of Consumer Services ("Committee", or "CCS"). Utilitech entered into a contract with the State of Utah, Committee of Consumer Services to review and respond to the Petition of Qwest Corporation (“Qwest or QC”) for Declaratory Ruling or Approval of the Sale of the Utah Assets of Qwest Dex, Inc. (“Dex”).

Q. Will you summarize your educational background and professional experience in the field of utility regulation?

A. I graduated from the University of Missouri, Kansas City, in 1978 with a Bachelor of Business Administration Degree, majoring in accounting. I hold a CPA Certificate in the State of Missouri and in the State of Kansas. I am a member of the American

Institute of Certified Public Accountants, the Missouri Society of Certified Public Accountants, and the Kansas Society of Certified Public Accountants. Since completion of formal education, my entire professional career has been dedicated to utility operations and regulation consulting.

From 1978 to 1981, I served as a public utility accountant with the Staff of the Missouri Public Service Commission. While employed by the Missouri Commission, I participated in rate case examinations involving electric, gas, water, steam, transit, and telephone utilities operating in Missouri. In December 1981, I accepted employment with Troupe Kehoe Whiteaker & Kent, a Kansas City CPA firm, in its public utility department. While with Troupe Kehoe Whiteaker & Kent, I was involved in the review, analysis, and presentation of a wide range of utility rate case issues and various other utility management advisory functions for both utility company and regulatory agency clients. In May 1983, I commenced employment with Lubow, McKay, Stevens and Lewis, an accounting and public utility consulting firm. While with that firm, I was involved in numerous regulatory proceedings and directed work related to various special projects.

In June 1985, Dittmer, Brosch and Associates, Inc. (now Utilitech, Inc.) was organized. The firm specializes in public utility regulatory and management consulting in the electric, gas, telecommunications, water, and waste water industries. As a principal of the firm, I am responsible for the supervision and conduct of the firm's various regulatory projects. A majority of the firm's business involves representation of utility commission staff and consumer advocate interveners in utility rate proceedings and special or focused investigations. In 1992, the firm was renamed Utilitech, Inc. to coincide with the admission of Mr. Steven Carver as a stockholder.

I have testified before utility regulatory agencies in Arizona, Arkansas, California, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico, Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings involving electric, gas, telephone, water, sewer, transit, and steam utilities.

Q. Have you previously participated in Qwest or U S West Communications ("USWC") regulatory proceedings?

A. Yes. My firm has represented various clients in prior Qwest/USWC proceedings in several states. In Arizona, I participated in the last four Arizona general rate cases involving Qwest/USWC on behalf of the Arizona Corporation Commission Staff and supported the Staff in negotiating a Price Cap Plan in settlement of the most recent rate case.[1] In Washington, I assisted the Washington Attorney General's Office, Public Counsel Section, in negotiation and subsequent review of that State's Alternative Form of Regulation (AFOR) plan.[2] I was also a witness in the two subsequent Washington general rate cases involving USWC and in a 1998 proceeding dealing exclusively with directory imputation issues.[3] In New Mexico, I served as a witness for the Commission Staff in the most recent USWC rate case.[4] In Utah, I served as witness for the Committee in USWC's last general rate case, Docket No. 97-049-08 and sponsored the directory imputation amount approved by the Commission in that Docket. I also represented consumer advocate clients in Utah and two other states (Iowa and

1 ACC Docket Nos. E-1051-88-146, E-1051-91-004, E-1051-93-183, and E-1051B-99-105
2 WUTC Docket Nos. U-89-2698-F and U-89-3245-P
3 WUTC Docket Nos. UT-950200, UT-970766 and UT-980948.
4 PRC Case No. 3008.

Washington) in regulatory proceedings associated with the acquisition of USWC by Qwest.[5]

Q. What is the purpose of your testimony in this Docket?

A. My testimony is intended to describe and sponsor, on behalf of the Committee, certain conditions and ratemaking treatment that should be imposed if the sale of Dex is approved by the Commission. Without such conditions and the proposed ratemaking treatment, the proposed sale of Dex is not in the public interest and should not be approved.

Q. Please summarize the recommendations that are set forth in your testimony.

A. The sale of Dex represents an extraordinary transaction intended to monetize and liquidate a major segment of Qwest's business that has historically been recognized above the line in establishing telephone service rates. Sale of the Dex income stream creates a substantial risk that the large gain on sale and cash proceeds from the transaction will be used to satisfy immediate creditor demands arising primarily from the non-regulated portions of Qwest's business, while the loss of the future income stream produced by directory publishing leaves the overall and regulated business financially weakened. In addition, the sale of Dex will frustrate future efforts of regulators to consider directory publishing income and cash flows in evaluating Qwest Corporation financial results or revenue requirement.

In addition, it must be recognized that the sale of Dex yields a very large gain that should not be attributed entirely to shareholders, as suggested in the Company's prefiled testimony. Instead, the intrastate Utah portion of the realized gain on sale of Dex should be used to secure for the next 30 years the imputation amount embedded

5 Utah Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

within customers' rates, so that no rate changes are required. Then, the excess of the Utah portion of the gain, above what is needed to secure embedded imputation amounts, should credited to customers upon closing of the Dex sale transaction. Alternatively, the Commission may direct some portion of the excess value be used to fund service quality or network improvement programs determined to be properly funded by ratepayers, subject to rigorous accounting and regulatory monitoring. These credits and long-term benefits to customers will recognize that historically Dex has been treated as a regulatory asset in Utah and that ratepayers have a vested interest in the value associated with the directory business, while at the same time providing near-term customer benefits that mitigate the risks created by the sale of Dex. After the recommended one-time customer credits are made, embedded imputation should remain frozen at existing levels for ongoing administration of the Utah price cap. The calculations supporting these recommendations are set forth in Confidential Exhibit CCS-1 and are explained in the "Gain on Sale Allocation to Utah" section of my testimony.

Q. How is the balance of your testimony organized?

A. My testimony is arranged by major topical area. A Table of Contents appearing at the beginning of the testimony sets forth this organization.

The Dex Sale Transaction

Q. Please describe the pending transaction to sell Qwest Dex.

A. Qwest Communications International, Inc. ("QCI"), the ultimate parent company owning Qwest Corporation, Qwest Dex and numerous other subsidiaries[6], has contracted to sell its entire interest in Qwest Dex, Inc. to a consortium of buyers including the Carlyle

6 A highly summarized Qwest Corporate Structure chart appears as Exhibit BGJ-2, attached to the testimony of

Partners III, CP III Coinvestment, L.P., and Welsh Carson, Anderson & Stowe IX, L.P. (hereinafter, "Buyer"). The sale of Dex is to occur in two stages, generally including the eastern portion of Qwest's local service territory in a "Dexter" transaction that has already closed, with a second stage "Rodney" transaction scheduled to close later in 2003. Consideration to be received by QCI is total cash of up to $7.05 billion, unless the Buyer requests QCI to retain an equity position of up to $217 million and/or provide debt financing to the Buyer to not exceed $300 million.

To transfer the Dex business as a going concern, numerous commercial agreements are incorporated into the Dexter and Rodney Purchase Agreements. These include a Publishing Agreement, a Directory List License Agreement, a Billing & Collection Agreement, a Noncompetition Agreement, a Trademark License Agreement and several other conveyance and service arrangement contracts. Collectively, these documents are intended to convey the entire Dex business to the Buyer in a manner that transfers the personnel, management, physical assets and automated systems, as well as rights to use significant intangible assets of Qwest without disruption of the business or dilution of the considerable going concern value of Dex.

Q. Why is it appropriate to characterize the sale of Dex as an extraordinary event?

A. The proposed sale represents the liquidation of a major segment of the consolidated Qwest business, the directory publishing segment that has historically been treated as a regulatory asset. The operating revenues, expenses and resulting income of this business segment have consistently been recognized within jurisdictional income for ratemaking purposes in Utah and other states, such as Washington. Never before has the directory publishing business of the incumbent local exchange carrier ("ILEC") in the Utah Qwest territory not been under common ownership and control with the ILEC. The

Qwest witness Brian Johnson.

sale of Dex was not reasonably foreseeable at the time of the Company's last rate case in Utah or before Qwest's financial liquidity concerns became acute in 2002.

Q. Isn't it true that the directory publishing business owned by Qwest and its predecessors has been transferred among affiliated entities in prior years?

A. Several internal reorganizations of the Qwest directory business have occurred in the past. These include the transfer of cash and certain directory assets into the new publishing affiliate in late 1983, the formation of U S West Communications and Media Group tracking stocks in 1996 with Dex being included as part of the Media Group, the 1998 spinoff of Media Group with Dex being purchased back by New U S West and then the merger with Qwest in 2000. However, there has never before been a true sale of Dex to a non-affiliated entity reflecting an arm's-length transaction and valuation of the directory publishing business enterprise. The sale of Dex therefore represents the extraordinary liquidation of a part of Qwest's Utah jurisdictional income stream that will no longer be available to support the Company's financial health or to contribute to its jurisdictional income for regulatory purposes.

Q. How was the Dex purchase price of $7.05 billion determined?

A. The purchase price was the result of negotiations between Qwest and the Buyers and appears to be reflective of the financial distress being experienced by Qwest as a result of its debt burden and lack of liquidity to service its debts.[7] The negotiated $7.05 billion purchase price is at the low end of the range of valuation estimates prepared by

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7 On December 23, Qwest announced a successful private debt exchange that will reduce total outstanding debt from approximately $24.5 billion to $22.6 billion and will extend some near-term maturities. In the Qwest Press Release announcing the debt exchange, the Company stated, "Over the past six months, Qwest's new leadership team has accomplished a number of steps to reduce debt and improve liquidity, including closing the sale of the first phase of its directory publishing business, QwestDex; amending the company's credit facility; and completing a new

Qwest's own financial advisors. I will explain the concerns with the purchase price later in the "Gain on Sale Allocation to Utah" section of my testimony.

Q. Even at the $7.05 billion price that you characterize as reflective of Qwest's financial distress, will the Company realize a large gain on sale that should be addressed by the Commission in this proceeding?

A. Yes. According to estimates prepared in the confidential response to Committee Data Request CCS-14S1, the pretax gain on sale expected to result from the Dex sale is approximately (START CONFIDENTIAL) (END CONFIDENTIAL) billion. After consideration of income taxes and the various allocations required to determine a Utah share of this gain, I believe that Utah customers are entitled to a present value net benefit of no less than (START CONFIDENTIAL) (END CONFIDENTIAL) million in after-tax dollars. The detailed calculation of this gain allocation is set forth in Confidential Exhibit CCS-1 attached to this testimony and is described in the "Gain on Sale Allocation to Utah" section of my testimony. The form in which Utah's share of this gain should be attributed to customers is discussed in the "Committee Recommended Conditions Upon Approval" section of testimony.

Q. How does Qwest plan to utilize the cash proceeds from the sale of Dex?

A. The net cash realized from the Dex sale, to the extent not mandated for Qwest Corporation customers by order of regulators, is intended to be directed toward the repayment of debt. The Company restructured its debt around an amended credit facility and term loan associated with the Dex sale transactions. Sections III and IV of Mr. Johnson's testimony describe the financial circumstances of the Company and the importance of the Dex sale in improving corporate liquidity. The recommendations

term loan."

contained herein give careful consideration to the Company's planned repayment of debt as well as customers' entitlement to participation in the realized gain associated with the sale of Dex.

Q. Will Qwest be required to pay income taxes on the gain it realizes from the sale of Dex?

A. Certain of the financial analyses prepared by Qwest's financial advisors in the transaction suggest that the (START CONFIDENTIAL)

(END CONFIDENTIAL), will offset the income tax liability otherwise payable on the Dex sale gain.[8] In response to Committee Data Request CCS-64, the Company estimated its consolidated NOL carryforward position to be approximately $5.82 billion as of December 31, 2001. However, since Qwest Corporation's regulated ILEC business and the directory publishing business have been consistently profitable, such NOL income tax benefits arise from non-regulated business segments and should not be attributed to any gain considered for crediting to telephone customers.

Regarding income tax liability, the key point is that the sale of Dex creates an opportunity for QCI to realize a cash benefit for its NOL carryforward position that is being retained for its shareholders because my recommendations provide for income taxes at statutory tax rates as if the entire gain on sale is taxable. Stated differently, the

8 See Exhibit CCS-2 Merrill, Lynch Transaction Overview at page 2, (START CONFIDENTIAL)

(END CONFIDENTIAL).

calculated income tax expenses allowed in Confidential Exhibit CCS-1 on the Dex sale gain will not be paid to the government, but will instead allow the parent company, Qwest Communications International, Inc. ("QCI"), to convert its NOL position into additional cash for use in repayment of debt.

Q. Would the Company be selling the Dex business if not for the poor financial performance of its non-regulated businesses?

A. No. As explained in the testimony of Qwest witnesses Ms. Scholl and Mr. Johnson, "QCI was required to sell Dex as a critical component of its strategy to preserve and strengthen the financial integrity of QCI. If QCI had been unable to sell Dex, the specter of bankruptcy for QCI was very real."[9]

Dex is a unique business enterprise encompassing the incumbent directory publishing position in the 14 states served by Qwest Corporation. Because of its position, Dex produces a consistently strong and growing stream of income and cash flow while requiring minimal capital expenditures. These characteristics are of sufficient value to yield over $7 billion in a distress sale of the business because the Buyers will enjoy this income stream upon sale of Dex. Unfortunately, QCI will sorely miss the income and cash flow produced by Dex after the sale, but the Company had little choice but to monetize this asset to meet the demands of its creditors.

Q. How do the commercial agreements that are incorporated into the Dex Purchase Agreement influence the value of the business?

A. The commercial agreements are required to convey the full value of the business to the Buyers because without such agreements Dex cannot function as a going concern in its present form. The new Publishing Agreement designates the Buyer as the "exclusive official publisher of all Directory Products" in the regions served by Qwest Corporation for the next 50 years, as well as a limited grant of "branding rights" to use the Dex names and marks and designation of the Buyer to receive all business referrals for directory advertising from within the Qwest Corporation region.[10] To preserve the public identity of the transferred business, a Trademark License Agreement grants the Buyer the right to use the "Qwest Dex" name in the conduct of the business.[11] Access to listings data, expanded use of listings, payphone placement rights, certain transition services and billing and collection services are provided for in other commercial agreements, which preserves the existing interfaces between Dex and the telephone company.[12] Without these agreements, the value of the Dex business enterprise would be substantially diminished.

Q. Is there a completely new agreement associated with the Dex sale that did not exist previously, when Dex was a wholly-owned affiliate of the telephone company?

A. Yes. A new Noncompetition Agreement appears as Exhibit M to the Dex Purchase Agreement. The Noncompetition Agreement obligates Qwest and its subsidiaries to not "publish, market, sell or distribute any Directory Products" in competition with the Buyers interests for a period of forty years, as long as the Buyer performs in accordance with the terms of the Publishing Agreement.[13] This new Agreement has the effect of precluding Qwest or its telephone operating subsidiary from re-entering the directory publishing business to attempt a take back of the directory advertising profits typically earned by the incumbent telephone holding company. Notably, there was no

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9 Direct testimony of Laura Scholl, page 8.
10 Exhibit D, Publishing Agreement at paragraph 4.2.
11 Exhibit J, Trademark License Agreement, paragraph 2.1 and Appendix A.
12 See Exhibits E, F, I, K and G respectively.
13 Exhibit M, Noncompetition Agreement, paragraphs 2.1 and 6.3. This Agreement also provides for non-

need for a Noncompetition Agreement between Dex and its telephone operating affiliate prior to the transaction because the common parent entity was able to direct the telephone company to not compete with Dex.

Q. How is the current proposed sale of Dex different from the 1984 transaction that created Dex's predecessor as a separate corporate entity?

A. The creation of U S West Direct in 1984 involved a non-arm's length transfer between corporate affiliates of employees, working capital and limited physical assets at book value, so as to move the directory publishing business outside of the telephone company (at that time Mountain Bell). There was no consideration given to the fair market value of the directory business enterprise in 1984 and there was no payment made to the telephone company for the fair value of the business or the considerable intangible assets associated with the directory business that were to be used by U S West Direct in the conduct of the business. Instead, for a limited period of time a publishing fee was paid by U S West Direct to Mountain Bell to partially compensate for the valuable official publishing rights, trade names and marks, incumbent publisher position and other benefits associated with affiliation with Mountain Bell. Later, these publishing fees were ceased by agreement to amend the publishing agreement between the telephone and publishing affiliates, to the extreme detriment of the telephone company, forcing regulators in Utah and other states to impute increasingly larger directory profits into the telephone company income statement to correct for inappropriate compensation from the directory publishing affiliate.

In contrast to the contrived affiliate transactions in the 1980's, the pending Dex sale is a true sale of the directory business for a negotiated cash price determined through interaction of informed parties in possession of relevant valuation information.

solicitation of employees and Dex senior management for a period of two years at Article 4.

The $7.05 billion sale price is at the low end of the market value of the Dex income stream[14] and is based in large part upon the continued use of the official directory status of Qwest's directories in the new Publishing Agreement as well as the use of other Qwest intangible assets granted to the Buyer in the various commercial agreements. For the first time since the directory business was removed from the telephone company by affiliate transaction in 1983, regulators are now able to review a market valuation of the directory publishing rights associated with the incumbent local exchange telephone business and determine an appropriate regulatory treatment for the Dex transaction.

Q. What practical regulatory problems are created by the sale of Dex if it is approved by the Commission?

A. The current liquidity problems faced by QCI are mitigated in the short term by the Dex sale cash proceeds in amounts targeted to satisfy creditors. However, as noted in my earlier testimony, the substantial annual Dex income and free cash flows will no longer be available to QCI to meet ongoing capital requirements in the longer term. The regulated telephone service business is inherently capital intensive, such that service quality is dependent upon continuing access to capital on reasonable terms. Absent an improvement in QCI operating and cash flow results beyond 2004, it is conceivable that the Dex sale represents only a temporary solution to more chronic problems impacting the Company's access to capital on reasonable terms. Therefore, one problem faced by the Commission is the continued weak and potentially worsening long-term financial condition of QCI after the Dex income stream is monetized.[15]

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14 See confidential Exhibit CCS-2 containing valuation summary pages from the confidential response to Data Request CCS 1-04, Attachments B and C, specifically the Dex valuation summary charts prepared by Merrill Lynch and Lehman Brothers, as presented to the Qwest Board of Directors August 19, 2002.

15 In the highly confidential response to CCS-61, the Company provided projections of its cash flow and cash

Another problem created by the pending Dex sale is the resulting absence of financial data for Dex in the event any future imputation calculation is needed by the Commission. Near term, the price cap regulatory environment would suggest that imputation calculations will not be required. However, any financial reporting of earnings by Qwest or any evaluation of the Company's financial condition and traditional revenue requirement would be frustrated by the absence of any Dex financial data needed to update imputation.

Finally, the sale of Dex and the large gain on sale to be realized by QCI on the transaction requires regulatory attention because the Dex business represents a regulatory asset. If the gain on this extraordinary sale event is ignored by regulators, as advocated by Qwest, customers of regulated telephone services will be denied equitable participation in the liquidation profits associated with a business that has historically been treated as a regulatory asset by regulators. The Utah share of the gain on sale should be attributed to ratepayers to offset the added risks borne by ratepayers if Dex is sold and to correct for embedded directory imputation values that are insufficient to fully recognize the Utah share of Dex sale gains. Shareholders should not be allowed to retain the gain on sale when they have not been "at risk" for the operations of the directory publishing business.

Q. Qwest witness Laura Scholl argues that Dex was initially developed by Mountain Bell's predecessor prior to regulation, without any ratepayer "contribution" to the business and with no risk to customers. Are these arguments reasonable?

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balances after meeting debt service and after the sale of Dex and the results indicate (START CONFIDENTIAL)

(END CONFIDENTIAL).

A. No. The directory business of Qwest (and its predecessors) in Utah has consistently been operated in coordination with the regulated telephone operations under common ownership, so as to capture the tremendous economic benefits of publishing directories in conjunction with (and as an offset to the costs of) providing telephone services. Like the other regional Bell holding companies, directory publishing grew up within the telephone business because the Bell companies were recognized by advertisers as publishers of the most complete "official" directories in their territories. In the next section of my testimony, I will explain the synergies and linkages between the telephone company and the publisher of official directories for the telephone company that caused the Dex business to be treated as a regulatory asset. I will also respond to the specific claims of Ms. Scholl regarding these matters in the "Rebuttal to Qwest Witnesses" section of testimony.

Dex Directory Publishing Is a Regulatory Utility Asset

Q. In your opinion, has the Utah portion of the directory publishing business operated by Qwest Dex and its predecessors been treated as a regulatory asset by the Commission?

A. Yes. The Utah portion of directory publishing has consistently been recognized within above-the-line intrastate earnings when the Commission has established a revenue requirement for the Company. As a result, the Company and its shareholders have not been at risk for Dex operating losses. Additionally, all of the incurred employee wages and benefits, other non-labor expenses and new capital investments associated with Dex have been allowed by the Commission when imputation was calculated in determining revenue requirements. Prior rate case Orders are illuminating in this regard.

Q. In your references to the directory publishing business as a regulatory asset, do you mean to imply that any Dex regulatory assets were actually recorded on the telephone company's books?

A. No. This Commission has treated the entire directory publishing business in Utah as a regulatory asset, but has not required any regulatory asset accounting on the books of QC or its predecessors since the transfer of the business to the publishing affiliate. Instead, imputation was calculated for ratemaking purposes only to effect the regulatory treatment of Dex (and predecessors) as if the printed directory business was entirely jurisdictional.

Q. At pages 25 through 28 of her testimony, Ms. Scholl references prior Utah PSC Orders regarding directory imputation but argues that the Commission did not approve or disapprove the transfer of directory publishing from the telephone company to its affiliate. How do you respond?

A. This Commission has consistently held that the public interest requires that the entire economic value of directory operations be recognized in revenue requirements by setting rates <u>as if directory operations had never been transferred</u>. First, in Case No. 85-049-02, the Commission approved a Division sponsored adjustment increasing the Company's contractual $15.5 million publishing fee by $1,990,000, stating:

> We find in favor of these parties and will accept the Division's proposed adjustment of $1,990,000. We find nothing in the Company's testimony or in the relationship between Mountain Bell and U.S. West which truly allows the risk of directory operations to be transferred to U.S. West Direct. The customers of the BOC's provide the revenue base on which U.S. West investors depend and thus no real transfer of risk can occur. We recognize that the new structure of the telecommunications industry created by divestiture and reorganization provides opportunities for a utility to evade regulation by forming subsidiaries. We have had occasion in recent years to state that diversification is a matter of the greatest concern to us. We have issued several orders outlining these concerns and articulating guidelines and requirements intended to

> ensure our ability to regulate utility operations in the public interest. The formation of this subsidiary took place without Commission approval.

In the 1988 general rate case, the Commission referred back to its 1985 Order and stated,

> In that docket we stated that revenues from directory publishing should support local rates. The evidence shows that the rationale we adopted in that case remains persuasive today. We find that directory revenues should be imputed to the Company's revenue in an amount based on a return on equity reflecting what USWC would have earned if the directory publishing had remained within the regulated utility. We find, consistent with the recommendations of the Division and the Committee, that ratemaking income should be increased by $4,933,000, in addition to the $8.77 million revenue adjustment previously agreed to by USWC. (Docket No. 88-049-07, Order p.18)

Rate orders in 1990 and 1991 (Dockets 90-049-03 and 90-049-06) resolved stipulated revenue requirement issues and incentive regulation matters, including an adjustment imputing directory revenues to the Company for ratemaking purposes. In a 1992 litigated rate case the Commission again addressed directory imputation:

> On January 1, 1984, then Mountain Bell, without the review or approval of this Commission, transferred its directory assets and personnel to US West Direct, a subsidiary of US West, Inc. US West Direct then published directories for Mountain Bell pursuant to a negotiated publishing agreement. In Docket No. 85-049-02 the Division argued that the transfer of assets was contrary to the intent of the Modified Final Judgment in that revenues from directory operations should support local rates. The Division also showed that the publishing fee provided a lower contribution than would have been the case if Mountain Bell had retained the directory operations. The Commission adopted the Division's recommendation that US West Direct's revenues and assets transferred by Mountain Bell should be treated for ratemaking as if they were still part of Mountain Bell's operations. In Docket No. 88-049-07, the Company testified that by 1988 the payments from U S West Direct to USWC had ended. In that docket, the Commission reiterated its

> position that revenues from directory publishing should support local rates. No party opposed this adjustment which adds $20,637,000 to test-year revenues and increases test-year income by $12,939,500. (Docket No. 92-049-05, Order p. 20)

In Docket No. 95-049-05, the Commission's Order summarized the aforementioned cases and then addressed several new USWC proposals. Specifically, the Company argued that competitive evolution of the telecommunications industry makes imputation of directory revenues to USWC inappropriate, that imputation is a subsidy that inhibits development of competition for local exchange services and that directory publishing is not linked to the provision of telecommunications services. The Company proposed a freeze in the level, and an eventual phase-out of the directory imputation. The Commission rejected the Company's proposal and stated the following:

> The Commission believes it is premature to reduce or eliminate the directory revenue imputation. Directories, including Yellow Pages, are an integral part of local exchange service. They are free to local exchange customers, in their exchanges, and their value is the direct product of local exchange service.

Finally, in Docket No. 97-049-08, the Commission recited much of the history noted above, as well as Judge Harold Green's Order in the AT&T divestiture case and the Wexpro I case to conclude at page 28, "…we conclude that the directory operations and assets and the directories themselves, including alphabetical and classified listings, were used and useful in USWC's utility business as they facilitate the use of USWC's telephone service." At page 29, the Commission further elaborated upon this finding in stating, "We conclude that the pre-1984 directory operations meet each of the three *Wexpro I* criteria: the operations and assets had been held in utility accounts prior to the transfer; utility funds had been used to develop the operations and assets; and the operations and assets facilitate the use of utility service and produce a useful utility service." The Commission also addressed the 1984 transfer of the directory business in the context of the Wexpro I criteria stating at page 30:

> The 1984 transfer violated these requirements because it was done without the Commission making any determinations and it was not done for fair market value. In the 1985 rate case, USWC tried to convince the Commission that the executed transfer was beneficial to the ratepayers and in the public interest. The commission rejected that contention. Also the commission could not have followed precisely the directive in *Wexpro I*, as it has never been presented with evidence of the directory operations' fair market value in previous USWC general rate cases. We believe, however, that the failure to follow the literal wording contained in *Wexpro I* is not an error. As noted, the Commission's treatment of directory operations since 1985 has been as if the operations had been retained by USWC. The directory operations imputation approach used by the Commission meets the goal of the *Wexpro I* decision by keeping customers in the same position as they were prior to the transfer. It maintains the equivalent of the 'appropriate benefit' they enjoyed in the pre-1984 years.

In its 98-049-08 Order (pages 31 through 33) the Commission also rejected the Company's other arguments against imputation, finding that imputation was not an improper subsidy, that imputation does not violate the First Amendment to the U.S. Constitution or the Utah Constitution, that imputation is not contrary to the 1996 Federal Telecommunications Act and that imputation is not anti-competitive. Ultimately, the Commission approved the $30.1 million imputation value ($18.6 million post-tax) that I advocated in testimony for the Committee.

From this history, several facts can be observed. First, the Company has systematically pursued the retention for shareholders of increasing shares of directory profits and business value since divestiture by transferring the publishing business outside of Mountain Bell, then by eliminating the negotiated publishing fee, and recently by arguing that competition is inhibited by regulatory recognition of directory publishing as an integral part of local telephone service. Second, the Orders show consistent findings that the past corporate reorganization and transfer of the directory publishing business was not approved by this Commission and that evolving competition does not justify allowing shareholders to retain directory profits. Third, directory profit recognition by regulators is not a subsidy, but is instead recognition that directories are an integral part of telephone service provision. Finally, the Commission has consistently found that ratepayers are entitled to full participation in directory profits as if the directory business had remained within the telephone company.

Q. In your opinion, does the pending sale of Dex involve the sale of a utility regulatory asset, even though certain of the tangible assets associated with the directory publishing business were transferred into an affiliated company in 1984?

A. Yes. The Commission has consistently treated the publication of directories by the Company in Utah as a utility asset for ratemaking purposes and has never approved prior directory asset transfers among affiliated entities. For example, the Commission Order in Docket No. 97-049-08 cites Company arguments that the directory business is operated independently and "…there is no direct USWC funding of publishing directories" and "US West Dex 'finances its own operations and pays the same fee to USWC as is paid by other directory publishers", and then concludes:

> Prior to 1984, the directory publishing operations and related assets had always been included in the utility operations of USWC. Operating expenses associated with directory publications had been included with all other utility operation expenses. Directory publishing capital assets were included in the utility's rate base and a return had been allowed upon those assets.
>
> In the context of current operations subsequent to the transfer, the Commission's directory imputation method treats the directory publishing operations as if USWC were still providing funding. We take all of the operating expenses of the current directory publishing activities,

> e.g., labor expenses, equipment expenses, distribution expenses, quantify the net value of capital assets involved, apply the allowed rate of return on those assets to determine the rate base return to include, and include the revenues associated with the operations. In this way, the current directory publishing operations are treated in exactly the same manner as they were in rate cases prior to 1984. (Order, page 27)

With this treatment historically and the finding on page 28 of the Order that, "…directory operations and assets and the directories themselves, including alphabetical and classified listings, were used and useful in USWC's utility business…", it is obvious that the Dex business continues to be treated as a utility asset by the Commission in spite of prior Company efforts to transfer and remove the business and its profits from regulatory consideration. The fact that the Commission has never approved the transfer of the directory publishing business among affiliated business units is acknowledged by Company witness Scholl at pages 25 through 28 of her testimony.

It should be noted that, before the Dexter/Rodney transactions, a permanent and complete transfer or sale of the directory publishing business has never previously occurred. Moreover, transfers of cash, equipment and other tangible property that are referenced at page 24 of Ms. Scholl's testimony did not include the permanent transfer of the far more valuable intangible assets associated with the official publishing rights of the telephone company. Instead, official publisher designation and the right to use intangible assets such as the telephone company tradenames and marks were granted by periodic affiliate contracts that initially required payment of a publishing fee, a form of "rent" for these valuable intangible assets. The terms of these affiliate contracts were found unreasonable by the Commission and largely ignored through the ratemaking orders that are cited herein.

Q. With this historical background in mind, are the Dex directory operations still integrally linked to the provision of local phone services and properly considered a utility asset?

A. Yes. The linkages between the white and yellow page directories of Dex and the telephone services of Qwest Corporation continue to include:

1) Listings that represent the primary information content of the directories are created in operation of the local phone business. To advertise in the Dex yellow pages you must have business telephone service.[16]

2) Usage of the white and yellow pages is driven by telephone customers' desire to make more effective use of local telephone services to reach businesses they wish to communicate with.

3) The usefulness of local telephone service is enhanced by the availability of both alphabetical and classified directories.

4) In the case of Dex directories, much of the revenues earned from yellow pages advertising are billed on local phone bills of QC telephone customers and are collected and processed by QC remittance centers.

5) Qwest payphones have been contracted to be provided with Dex directories.

6) Directories of telephone affiliates are published with prominent placement of identifying tradenames and trademarks linking them to the telephone company.

7) The public is likely to perceive Dex directories to be endorsed by the telephone company and thereby the "official" book that is accurate, current and comprehensive with respect to the phone number listings controlled and assigned by Qwest.

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16 Per Qwest web site description of Qwest Dex yellow page advertising. See http://www.qwest.com/pcat/large_business/product/1,1354,55_4_24,00.html

8) Qwest refers customer inquiries regarding directory advertising to Dex, where such referrals may lead to incremental sales of advertising.

Simply stated, Dex publishes the "official" phone books for Qwest, and these directories offer significant value to advertisers as well as supra-competitive profits to the publisher. For all of these reasons, the traditional regulatory practice for many years, as codified in the FCC's Uniform System of Accounts and recognized by this Commission for many years, is to treat directory advertising and other directory publishing revenues as above-the-line for ratemaking purposes.

Q. Many of the linkages between the telephone company and the directory operations that you describe appear to represent intangible goodwill assets enjoyed by the publisher from its relationship with the telephone company. Is this goodwill value recognized anywhere on the books of Dex or the telephone company?

A. No. Going concern or goodwill is not an investment that required contributions of cash or other assets by Qwest or QCI, but instead this value has arisen from doing business successfully over a period of time. For this reason, there are no recorded goodwill assets on the Dex or QC balance sheet associated with this value. In the pending transaction, $7.05 billion is being paid to acquire the Dex going concern business and its goodwill, and consistently large income stream. The origin of this goodwill and income stream arises from linkages into the telephone company that have existed for decades, linkages that are carefully preserved in the many commercial agreements that are made a part of the transaction.

Q. Is the relationship between QC and Dex unique, or do the other three regional "Bell" holding companies also publish telephone directories that tend to be more profitable than the directory operations of non-ILECs?

A. According to information contained in a confidential Qwest Dex Strategy White Paper provided in response to Data Request No. CCS-30 at page 5, the Regional Bell Operating Companies ("RBOCs") have very attractive revenue and Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") characteristics:

(START CONFIDENTIAL)

(END CONFIDENTIAL).

These comments indicate RBOC market dominance and the distinctively higher earnings margins and cash flows realized by the incumbent local bell company publishers, relative to the lower-margin competitors' financial performance. Such market dominance and financial performance among the RBOC publishers, relative to non-RBOC competitors, is indicative of the strategic advantages derived by linkages to the telephone operation and the benefits of official publisher status.

Q. Have Dex profits and cash flow trends continued to improve in the past few years?

A. Yes. According to the Dex Confidential Descriptive Memoranda prepared to describe the Dex business in soliciting bids from potential acquirers, the recent year's unaudited actual and projected Dex revenue and EBITDA values were:

(START CONFIDENTIAL TABLE)

(END CONFIDENTIAL TABLE)

Q. Do the linkages between the telephone company and the publishing affiliate justify the continued attribution of virtually all of the value of the directory business to telephone ratepayers, even when the directory publishing business is sold?

A. Yes. Recognition of the excessive profits of the directory publishing affiliate has been necessary historically when setting rates because these profits are created from the unique benefits of affiliation with Qwest's telephone business, benefits that arise from and are integrally related to the provision of local telephone services. Upon sale of the Dex business, the ongoing earnings stream reflective of the linkages is to be transferred, but the Commission can now consider the fair market value of the directory operations business and determine the final one-time adjustment and any other conditions needed to properly attribute this value to ratepayers.

Q. At page 12 of your testimony, in describing the pending Dex sale transaction, you stated, "The commercial agreements are required to convey the full value of the business to the Buyers". Do the commercial agreements serve the purpose of preserving the linkages between Qwest Corporation's ILEC telephone business and the directory publishing business, after Dex is no longer an affiliate of Qwest Corporation?

A. Yes. The unique benefits of affiliation between QC and Dex, that were assured in the past through common corporate ownership and control, are now carefully formalized within the commercial agreements that are incorporated into the Dex sale contracts.

Q. How does the new Publishing Agreement between Dex Holdings L.L.C. and Qwest Corporation preserve the benefits of linkages between the regulated telephone company and the directory publisher?

A. The new Publishing Agreement designated the Buyer as Qwest Corporation's exclusive official publisher of all Directory Products in its region for a 50 year period, with certain Qwest Dex "branding rights" and a right to any referrals QC makes concerning directory advertising. (Exhibit D at 4.2).

Q. Have the parties to the Dex sale agreements also made provision for the continued use of Qwest Dex intangible assets, so as to maintain the identity of the buyer as the publisher of the "official publisher" of Qwest's directories?

A. Yes. The new Trademark License Agreement grants the Buyer the right for five years to use the "Qwest Dex" trademark on its products within the directory publishing service area, to provide continuity in the public identity of the business. (Exhibit J at 2.1).

Q. Earlier in your testimony, you mentioned the new non-competition agreement that was negotiated to protect the Buyer against Qwest Corporation's potential re-entry into the lucrative RBOC directory publishing business. How does this agreement work?

A. The new Non-Competition and Non-Solicitation Agreement serves to prevent Qwest from marketing, selling or distributing Directory Products in the Dex region in competition with the Buyer within the 40-year term of the Agreement. Qwest also agrees to not solicit for hire any employees or management transferred to the Buyer for a period of two years. (Exhibit M at 3.1, 4).

Q. Is this Agreement intended to be binding upon Qwest Corporation ("QC"), the entity regulated by the Commission?

A. Yes. Qwest Corporation is listed as one of the "Qwest Parties" in the preamble of Exhibit M that are subject to the restrictions precluding in-region publishing of listings and advertising. However, even though QC surrenders its right to publish white and yellow pages directories in Utah and other local exchange areas it served for 40 years, Qwest Corporation is not the owner or seller of Dex and will not receive any of the proceeds from the sale of Dex. The non-competition agreement recognizes and eliminates the risk to the Buyer that QC might choose to re-enter the directory publishing business as a formidable competitor because of the many advantages enjoyed by RBOC official directory publishers.

Q. Has provision also been made within the commercial agreements between Buyer and Seller for a continuation of billing and collection services by QC, for the benefit of the new owner of Dex?

A. Yes. A new Billing and Collection Services Agreement allows the Buyer to receive billing and collection services from Qwest Corporation, services not received by any other directory publisher. (Exhibit G) The linkage between the telephone company and the Dex business is reinforced by providing Dex advertising customers with a combined bill that also reflects the customer's Qwest Corporation telephone service charges. Creation of the combined end-user bill creates an accounts receivable balance for advertising as well as telecommunications services.[17]

Q. Will Dex continue to be the supplier of directories for QC payphones throughout Utah and the other states served by QC?

A. Yes. A new <u>Public Pay Stations Agreement</u> provides for the continued placement of Dex directories within Qwest Corporation's payphones. (Exhibit I)

Q. You previously mentioned the extraordinary profitability and cash flow realized by RBOC-affiliate directory publishers like Dex. Will the Buyer of the Dex business receive and employ the human resources, automated systems, customer information and management personnel required to maintain business continuity and profitability?

A. Yes. Under the Rodney <u>Purchase Agreement</u> and the related Exhibit B <u>Contribution Agreement</u>, all of the existing tangible and intangible assets, allocated employees, designated management personnel and customer data of Dex that is related to the Rodney business will be transferred and sold to the Buyers. Thus, the Buyer receives the full going concern business at closing and is assured of no diminution of that value because of the protections built into the various other commercial agreements described above.

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17 Qwest Corporation has also agreed to (START CONFIDENTIAL) (END CONFIDENTIAL) to the confidential <u>Agreement for the Provision of Billing and Collection Services</u>, identified as Exhibit G to the Rodney Sale Agreement.

Q. After the Rodney Purchase Agreement and all of the incorporated commercial agreements are made effective, will the resulting complete and permanent liquidation of the Dex directory publishing business preclude any future consideration of the directory publishing business as a regulatory asset by the Commission?

A. Yes. QCI is left with only cash proceeds until applied to debt repayment, and with no further opportunity to publish directories on its own behalf.

Risks to Customers Created by the Sale of Dex

Q. What are the risks to customers and regulatory issues that are created by the pending Dex sale?

A. The sale of Dex creates substantial new risks and issues to be addressed by the Commission:

- The liquidation of the directory business removes a large income stream that has historically been recognized by regulators to establish cost-based revenue requirements.

- The sale of Dex to a non-affiliated Buyer will cause regulators to lose access to directory publishing financial and operational information that is needed to evaluate telephone company financial performance and revenue requirement.

- Sale of the Dex income stream also substantially reduces the long-term ability of the Qwest consolidated businesses to generate cash flow from operations needed to service debt and attract capital on reasonable terms.

- Sale of Dex provides a market valuation for the directory publishing regulatory asset and a corresponding gain on sale that must be attributed either to shareholders or ratepayers. Qwest's witnesses suggest that none of the gain should be attributed to telephone customers.

- Sale of Dex will cause the actual production and distribution of directories to be performed by a non-affiliated entity for the first time in

Company history. The sale potentially reduces the Commission's ability to regulate Qwest's directory publishing obligation to customers.

- Sale of Dex will likely increase corporate shared costs to be borne by QC.

Q. Please explain the risks created when the directory business is no longer available for imputation in any future proceedings in which the Commission may be concerned with Qwest's Utah intrastate earnings and financial condition?

A. The future earnings and cash flows of Dex are being sold by Qwest to improve liquidity and satisfy the near-term demands of creditors. As a result, there will not be directory earnings to impute and no corporate accounting information from which to determine the profitability of the Dex business that continues to operate in Utah under new ownership. The sale of the income stream and the absence of Dex profitability data exposes customers to the risk that future imputation will be impossible to quantify or justify with factual data. For the first time in the Company's history, Dex is the subject of a true sales transaction that will permanently transfer all of the tangible property, employees, customers and specific intangible assets that are required to install the buyer as official publisher for the next 40 years.

Q. Why should Utah regulators care about access to Dex financial information if traditional rate cases are not likely to occur in the future in Utah?

A. Even under price cap regulation that does not require periodic rate cases to change rates, the Commission must continue to monitor the financial performance, service quality and overall operations of the Company. Regulatory review of financial reports submitted by Qwest in the past could include consideration of the additional profits and cash flows from the directory business by imputation, even though that financial data was actually derived from the records of a corporate affiliate. After Dex is sold to a non-affiliated buyer, there is likely to be no regulatory access to directory publishing information and the Commission will be left to guess what directory profits might have been if Dex had not been sold. The reported earnings of Qwest Corporation in the future will be chronically understated if the historically large and growing directory publishing imputation adjustment cannot be added into such earnings.

Q. Is the financial condition of Qwest Corporation and its parent QCI of vital importance to the Commission, even under price cap regulation in Utah?

A. Yes. The Company must continue to have access to capital on reasonable terms to provide high quality regulated services. A major segment of Qwest's business that has been extremely profitable for many years is being liquidated to satisfy creditors' demands over the next few years. However, by the Company's own consolidated projections of cash flows with the complete sale of Dex within this year, the ability to (START CONFIDENTIAL)

(END CONFIDENTIAL).[18] In a very real sense, the sale of Dex appears to be a corporate survival tactic that compromises the long-term strength of the business in an attempt to increase liquidity and meet near-term debt repayment obligations. Qwest's significant financial problems were not caused by financial failures within the regulated business, yet a regulatory asset is being liquidated in an effort to remedy Qwest's liquidity crisis.

Q. Do you agree with the testimony of Qwest witness Mr. Brian Johnson that the sale of Dex is important to the continued financial viability of QC and the parent company QCI?[19]

18 See Highly Confidential financial projections in CCS-2-61.
19 Brian G. Johnson Direct Testimony, page 2.

A. Yes. Mr. Johnson describes in some detail the deterioration in Qwest's consolidated financial performance, credit rating downgrades to junk status, accounting investigations and Qwest's resulting liquidity crisis. While it may have been possible for Qwest to sell assets or business segments other than Dex, issue new securities at extremely high cost or reorganize the business through a merger, the sale of Dex was an attractive option for several reasons. Dex is an attractive business segment to sell because of its enviable market position, robust cash flows and financial strength and will therefore yield cash proceeds upon sale that are large enough to measurably improve Qwest's financial condition by reducing debt leverage. Notably, the Dex sale is larger, but similar to other directory sale transactions recently announced by Sprint, McLeod USA and Bell Canada to improve liquidity and access to capital markets.[20]

Q. Should the financial viability of Qwest and the desire of QCI to de-lever its balance sheet prevent the Commission from considering the interests of ratepayers in the Dex business and the proper distribution of the gain being realized from the sale?

A. No. In my opinion the interests of ratepayers in the Dex business is not subordinate to the interests of shareholders in preserving the gain and cash proceeds for corporate purposes. A reasonable attribution of the gain to Utah customers is necessary to secure existing imputation levels (or an economic substitute for such imputation) and ensure that the sale of Dex is consistent with the public interest. It remains possible that Qwest will not survive its liquidity crisis even with the sale of Dex. If a Qwest bankruptcy eventually occurs, there may then be less of an opportunity to be sure that customers' interests in the Dex business are safeguarded.

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20 Sprint agreed to sell its directory business to R.H. Donnelley Corp for $2.23 billion in cash, as announced in September 2002. McLeodUSA Publishing was sold to U.K.-based Yell Group for $600 million in a deal announced in January 2002. The Bell Canada Directories business was sold for $3 billion in cash (Canadian) to KKR and the Teachers' Merchant Bank in a deal announced in September 2002.

Q. Does the Rodney Agreement explicitly recognize and provide for regulatory impacts that may be imposed by this Commission and by other state commissions?

A. Yes. At paragraph 5.4(b)(ii), the Rodney Agreement allows Qwest to not close the Rodney phase of the Dex sale in the event regulatory conditions imposed by states, including net revenue reductions or mandated incremental capital expenditures, become large enough to qualify as a "material regulatory impact" or "MRI". A separate "confidential letter of understanding" defines the MRI threshold to be (START CONFIDENTIAL) (END CONFIDENTIAL).[21] Thus, Qwest can terminate its obligations under the Rodney agreement only if net economic losses from regulatory conditions reach this threshold value. Qwest's confidential Seller's Disclosure Schedule at Section 3.4 identifies (START CONFIDENTIAL)

(END CONFIDENTIAL).

Q. Has Qwest assumed any MRI reduction will occur within its financial projections contained in the highly confidential response to CCS-61?

A. (START CONFIDENTIAL)

(END CONFIDENTIAL) to the cash proceeds from the Rodney transaction are assumed in the year 2003, when Rodney is projected to close. In addition, the projections also appear to assume (START CONFIDENTIAL)

(END CONFIDENTIAL) to the Buyers pursuant to the

21 See MRI Side Letter captioned, "Confidential Letter of Understanding".

Rodney Agreement.[22] Thus, the cash proceeds ultimately available to the Company for debt repayment are uncertain, depending upon the magnitude of regulatory demands on behalf of ratepayers as well as the extent to which Qwest contributes seller financing to the transaction.

Q. Please explain how the sale of Dex can be expected to increase corporate shared costs to be borne by QC.

A. Qwest incurs certain corporate overhead costs related to its corporate executive management, finance and accounting, treasury, human resources, marketing and other centralized administrative functions. These costs have historically been pooled and assigned or allocated across the various Qwest subsidiary operations, including QC and Dex, with Dex receiving a substantial portion of such charges.[23] Upon sale of Dex, for a limited transition period of 18 months after closing, some of these centralized corporation service functions will be provided to the Buyer pursuant to a Transitional Services Contract.[24] However, this contract may not fully offset the additional cost burden upon QC when Dex is no longer a corporate affiliate receiving a full allocated share of corporate administrative overhead costs. After the 18-month term of the Transition Services Agreement, corporate shared costs that cannot be reduced after

22 In its response to Data Request CCS-60, the Company stated, "The Buyer has orally informed Qwest that it will need up to $117 million of equity in addition to amounts committed by others in the Rodney Equity Financing Commitment Letter. Qwest has the option of funding that equity to ensure closure of the transaction. However, Qwest expects that the buyer will cover that amount itself or will arrange for other third parties to cover it…At this point, it is too early to speculate on a final result. Decisions relating to whether Qwest will ultimately contribute any equity will be made as the Rodney closing nears in 2003."

23 According to Qwest's confidential response to Data Request CCS 2-49, Attachment A, QCS headquarters cost allocations to Dex have ranged from (START CONFIDENTIAL) (END CONFIDENTIAL) million in the years 1999, 2000 and 2001, information technologies affiliate charges were more than (START CONFIDENTIAL) (END CONFIDENTIAL) million in 2001, and significant other legal, property administration and other affiliate charges were attributed to Dex.

24 Exhibit K to the Rodney/Dexter Agreements is a Transition Services Agreement.

Dex is sold will necessarily be absorbed by allocation across the remaining affiliates including QC's regulated business. In an effort to evaluate this concern, the Committee submitted Data Request CCS-1-29 asking for "a calculation of the expected annual impact upon Qwest Corporation's Utah-intrastate charges from affiliates as a direct result of Qwest Dex being sold and no longer receiving its allocated share of such affiliate charges", to which the Company replied, "Qwest has not prepared the requested calculation. Preparation of the requested information would require a special study".

Beyond the effect of more narrowly allocated shared corporate costs, another cost increase to be imposed by the sale of Dex relates to the commitment by the Qwest parties to purchase on a take or pay basis at least (START CONFIDENTIAL) (END CONFIDENTIAL) per year in directory advertising from Dex for each of the next 15 years after the sale.[25]

Committee Recommended Conditions Upon Approval

Q. What is your recommendation regarding the Dex transaction in Utah?

A. If not for the acute financial condition of Qwest and the possibility that selling Dex may allow the Company to survive its financial crisis, I would recommend that the Commission reject the sale of the directory publishing business. However, given the present economic circumstances of Qwest as well as the risks created by the transaction, I recommend approval of the Dex sale, subject to imposition of the following specific conditions by the Commission:

1) The Utah portion of the gain on sale to be realized by Qwest should be attributed entirely to QC customers because the business enterprise

25 This is referred to as the "Annual Ad Commitment" in Exhibit A to the Rodney Agreement.

being sold is a regulatory asset of the utility, as evidenced by a series of previous orders of the Commission.

2) The Utah share of the gain should first be used to fund and secure continuing imputation at the $30.1million level that is embedded within present rates, recognizing that price cap regulation will continue this level of imputation into the indefinite future. A condition of sale approval should be the continued credit of $30.1 million of directory revenues to telephone company operations in all future financial reporting, earnings investigations and any revenue requirement calculations prepared for submission to the Commission for each of the next 30 years. Implementation of this condition should include a finding that Qwest Corporation shall not petition the Commission seeking any exogenous price cap adjustment to remove or reduce the $30.1 million of embedded directory imputation.

3) The remaining Utah share of the gain, after accounting for embedded imputation in item (2), should be flowed to QC's Utah customers on a one-time basis, through either a customer bill credit or the exogenous adjustment provisions of price cap regulation.

4) In the event the Commission determines that specific network investment commitments or desirable service quality improvement programs that require financial commitments by QC would not otherwise occur, these initiatives could be funded with a portion of the remaining Utah share identified in item 3, above. Any dedication of ratepayer funds in this manner should be subject to rigorous reporting and regulatory monitoring with administration through discrete regulatory liability accounts on QC books.

These measures will ensure that Utah customers are not adversely impacted by ceasing imputation and raising future rates, while also ensuring that the full economic value of the Dex business enterprise is attributed to customers, rather than shareholders. Since most of the Utah share of the Dex gain on sale is retained by Qwest to fund the embedded imputation liability to customers, the vast majority of cash is immediately available to reduce corporate debt. The amount of one-time customer credits that could be characterized as a Material Regulatory Impact under this recommendation provides some additional compensation to customers to mitigate the risks arising from the transaction. Any expansion or extension of Utah service quality programs could help to minimize the risks to service quality that may arise from Qwest's financial distress.

Gain on Sale Allocation to Utah

Q. Was the Company asked to provide a calculation of the gain on sale anticipated to be realized from the Dex sale transaction?

A. Yes. Data Request CCS-14 requested information about the book and tax basis of the business interest to be sold and detailed calculations of the estimated book and tax gain on sale to be realized by QCI as a result of each (Dexter/Rodney) transaction, with supporting workpaper calculations, assumptions and underlying source documents. The Company provided a narrative response stating:

> An accurate estimation of the book and tax basis for the Dex business interest to be sold and the final sales price remains impracticable at this time. However, Qwest has now prepared a preliminary estimate of the gain on the sale of Dex and a computation of the portion of that estimated gain related to Utah. Qwest's preliminary estimate is provided in Confidential Attachment "A".
>
> The gain estimate assumes a sales price of $7.05 billion. The actual sales price will not be known until after computation of the Post-closing Working Capital Purchase Price Adjustment set out in Paragraph 2.9 of the Rodney Purchase Agreement and the Buyer's and Seller's agreement on that adjustment.
>
> This preliminary gain calculation relies on estimates of net book value and transaction costs. Neither the actual net book value at closing nor the actual transaction costs will be known until after closing.

I utilize the Company's estimated gain calculation on confidential "Attachment A" from this response as the starting point for information set forth in my Confidential Exhibit CCS-1 and have included each step of the Company's estimated Utah gain calculation (column B) for comparison to the Committee's recommended calculations (column C). In this way, each disagreement or potential issue regarding the gain calculation and allocation to Utah is highlighted for consideration by the Commission.

Q. Did Qwest provide the estimated values shown at lines 1 through 4 of Confidential Exhibit CCS-1 in its response to Data Request CCS-14S1?

A. Yes. The sale price of $7.05 billion is the combined Dexter and Rodney price according to the Purchase Agreements, assuming no working capital adjustments are ultimately applied to this value. The (START CONFIDENTIAL) (END CONFIDENTIAL) is approximately equal to the total assets of Dex Holdings as of December 31, 2001 and contains mostly current assets that will be subject to the purchase price true-up provisions referenced above.[26] The "transaction costs" subtracted from sale proceeds at line 3 include estimates of the total fees payable to investment bankers, legal and other advisory personnel involved in the transaction.[27] As noted in Confidential Exhibit CCS-1, the Committee has not challenged any of the Company's estimates regarding purchase price, contributed assets or transaction costs.

26 The Company's confidential response to Data Request CCS-01, Attachment B, provided restated financial statements for Qwest Dex Holdings, Inc. indicating total assets of (START CONFIDENTIAL) (END CONFIDENTIAL) at 12/31/2001.

27 In response to Data Request CCS 1-06, the Company itemized actual transaction costs payable through September 30, 2002 that totaled $3.7 million. However, large amounts payable pursuant to engagement letters with Lehman Brothers and Merrill Lynch are not due until closing.

Q. Is the $7.05 billion purchase price negotiated between the Buyer and QCI representative of full, fair market value for the Dex business?

A. The increasingly urgent financial difficulties facing Qwest were widely known at the time the Company was soliciting interest in the purchase of the Dex business. In addition, the large size of the business and the Company's need for cash consideration tended to limit the number of potential buyers in a position to finance such a transaction. These factors detracted from Qwest's ability to get top dollar for Dex and (START CONFIDENTIAL) (END CONFIDENTIAL).[28] In the "fairness opinions" prepared for Qwest by Merrill, Lynch and Lehman Brothers, the $7.05 billion negotiated price for Dex is near (START CONFIDENTIAL) (END CONFIDENTIAL). I have included in Confidential Exhibit CCS-2 copies of presentations made to the Qwest Board of Directors by its financial advisors, Merrill Lynch and Lehman Brothers, that provide an overview of the transaction and summarize the Dex valuation study work performed for Qwest. From this information, it is reasonable to conclude that the negotiated purchase price for the Dex business is just barely adequate to be considered fair to Qwest's shareholders and customers. Nevertheless, to be conservative in my recommended ratemaking conditions for approval of the transaction, I have not contested or adjusted the $7.05 billion purchase price.

28 Confidential response to Data Request CCS-1-04, Attachment A, page 7, (START CONFIDENTIAL) (END CONFIDENTIAL).

Q. At line 5 of Confidential Exhibit CCS-1, you have reduced the Dex sale proceeds by almost (START CONFIDENTIAL) (END CONFIDENTIAL) for income taxes at a 38.25 percent composite tax rate. Will QCI pay any income taxes on the Dex sale gain it experiences?

A. Probably not. As mentioned in my earlier testimony, QCI has accumulated large net operating loss ("NOL") carryforward balances for income tax purposes. In addition, the stock of LCI was included by Qwest in the assets being acquired by the purchaser for the apparent purpose of reducing income taxes otherwise payable on the transaction.[29] However, because the sources of negative consolidated taxable income in past years giving rise to the NOLs and the tax circumstances of the LCI entity are not related to the business operations of either the QC regulated telephone business or Dex, I have attributed Qwest's shelter from income taxes on the gain entirely to shareholders. There is no denying that the sale of Dex creates an opportunity for Qwest to realize these tax benefits as additional cash flow via tax savings, so shareholders are clearly advantaged by regulatory calculations (such as Confidential Exhibit CCS-1) that attribute full statutory income tax rates to the Dex gain even though such income taxes will not be paid by the seller. According to the Company's response to Data Request CCS-64, "The Company has not finally determined what net operating losses, if any, will be used to offset any taxable gain resulting from the Dex sale. The Company has not computed its consolidated taxable income or loss for the tax year ending December 31, 2002."

Q. Please explain the purpose for Lines 7 through 13 of Confidential Exhibit CCS-1.

29 Refer to footnote number 3 and the response to Data Request CCS-64 indicating Qwest's consolidated Federal NOL position at $5.82 billion as of 12/31/2001.

A. These lines disclose four allocations proposed by Qwest that would reduce the Dex sale transaction and resulting gain to be attributed to the portion of the directory publishing business that has historically been subject to regulatory jurisdiction or imputation. Specifically, the Company's confidential preliminary gain calculation that was provided in response to Data Request CCS-14S1 carves out portions of the sale price and resulting gain for attribution to (START CONFIDENTIAL)

(END CONFIDENTIAL). For each of these portions of the Dex sale, the Company would attribute the realized Dex sale gain to shareholders, rather than to the basic printed directory business that has been recognized in imputation calculations.

Q. Does the LCI business have anything to do with directory publishing or Dex?

A. Aside from common ownership by Qwest, LCI has nothing to do with Dex or directory publishing. According to the response to Data Request CCS-63, "LCI International owns a limited partnership interest in Qwest N. Limited Partnership. Qwest N. Limited Partnership leases telecommunications equipment to Qwest Communications Corporation, which is the long distance and data networking subsidiary of QCI. Because it is unrelated to Dex and appears to have been bundled into the Dex sale transaction at Qwest's request to realize certain income tax advantages available to Qwest,[30] I agree with the Company that the sale proceeds and gain amounts attributed to LCI should be excluded from my calculations on Confidential Exhibit CCS-1. However, as noted in Confidential Exhibit CCS-1, (START CONFIDENTIAL)

30 In response to Data Request CCS-2-12, the Company stated, "The LCI business was included in the Dex sale to maximize the net proceeds received by Qwest."

(END CONFIDENTIAL)

Q. The next allocation of Dex sale proceeds and gain shown on Confidential Exhibit CCS-1 at line 9 is for an "Allocation to New Ventures". What is "New Ventures" and why is it excluded in allocating the Dex sale gain to the Utah jurisdiction?

A. As implied by the label, New Ventures is the portion of Dex that engages in non-traditional businesses such as internet directories, direct marketing services and other activities beyond directory publishing. Historically, these activities were not included within the core directory publishing division of Dex and were not included in calculation of imputation by regulators. Therefore, I concur with Qwest's calculation of the percentage of the estimated gain on sale of Dex that should be attributed to the New Ventures business. This percentage was based upon the relative revenues of the New Ventures activities to total Dex revenues and is likely to overstate the portion of Dex gain properly attributed to New Ventures because these non-traditional "ventures" are likely to be less profitable than the established publishing business. However, to be conservative in the Committee's calculations in Confidential Exhibit CCS-1 and to reduce the number of issues in this proceeding, I accept the Company's revenue-based allocation to New Ventures.

Q. So far, in describing the line items in the Confidential Exhibit CCS-1 gain allocation schedule, nothing has been "at issue" in column D. However, when we get to the "Allocation to Secondary Directories" at line 10, you have completely rejected the Company's treatment. What are secondary directories?

A. Secondary directories are discretionary additional phone books produced by Dex within the QC territory to earn additional advertising revenues. Typically, they include regional and specialized directories, such as the "On The Go" directories for use with cellular telephones and in automobiles. In Utah, the Dex secondary directories include the Wasatch Front, South Valley Area, Price-Helper and Vernal directories, which are additional books marketed to advertising customers by addressing the value the advertiser receives, considering the circulation of the directories, the scope of the directories and the quality of the directories.[31]

Q. What is your understanding of the Company's rationale to allocate some of the gain on the Dex sale to its shareholders, rather than to Utah customers, because of the secondary directories that are published by Dex?

A. According to the response to Data Request CCS 2-08, "Secondary directories are published at Dex's discretion in order to compete more effectively in the advertising market and maximize advertising sales by providing directories that allow advertisers to focus their advertising message to a specific geographic scope which best represents their customer base." Additional reasoning for the Company's position is stated in the response to Data Request CCS 2-20:

> Qwest excluded secondary directories and non-Qwest listings…because these revenues are distinct from the revenue historically associated with directory imputation; namely, revenues associated with Qwest customer listings in primary directories. The stated basis for directory imputation is the relationship between local exchange service and the directory publishing business transferred from the Bell operating Company subsidiaries of U S WEST, Inc. in 1984. That transferred business did not include non-Qwest listings, secondary directories or internet-based products and services.

31 See Qwest's response to Data Request CCS 2-23.

Q. Should secondary directories be excluded in allocating the Dex gain on sale to Utah?

A. No. Imputation in Utah was never limited to “Qwest listings in primary directories”. Secondary directories represent additional products through which the directory publisher can prudently maximize revenues and profits, by scoping and publishing additional directories in targeted markets that do not conform strictly to telephone exchange areas. This is not a new or particularly innovative practice and is not unique to Dex. Prudent management is reasonably expected to seek growth opportunities in new markets and leverage recognized brand names like Qwest and U S West. Indeed, if the telephone company had remained in the directory publishing business after 1983, nothing would have precluded adding secondary book publications to maximize revenues, so as to reduce the net cost of providing telephone service.

Q. Has Dex incurred any significant costs or investment risks associated with publishing secondary books that have been attributed to shareholders by excluding such costs or investments in calculating imputation adjustments?

A. No. The entire directory publishing business of Dex (and predecessors) has been fully included in imputation calculations, including any incremental investments and expenses associated with developing and publishing secondary directories.

Q. The quoted response to Data Request CCS 2-20 also mentioned “non-Qwest listings”. Is this the issue appearing at line 11 of Confidential Exhibit CCS-1?

A. Yes. The Company seeks to retain a significant additional share of the gain to be realized upon the sale of Dex because its primary printed directories contain some listings that are not QC telephone company customers. Qwest proposes to carve out part of its directory revenues (and an equivalent share of the Dex sale gain) based upon the percentage of listings contained within its primary directories that are not

Qwest telephone subscribers. For example, if the white pages listings in Salt Lake City are determined to contain 90 percent QC customers and 10 percent customers who are served by competitive or independent local exchange carriers, the Company would attribute 10 percent of yellow pages advertising revenues (and the resulting Dex gain) to its shareholders. This proposed carve out, like Qwest's treatment of secondary directories, appears related to the Company's theory that imputation has been ordered only because the listings of telephone company subscribers appear within Qwest directories.

Q. Was imputation required by regulators solely because of the inclusion of telephone company listings within the published directories?

A. No. There are many linkages between the telephone company and the directory publishing operation, only one of which is the listing linkage. My earlier testimony explained the many bases for imputation as well as the history of Utah Commission decisions on this matter.

Q. Does Dex seek to include the listings of CLECs and independent telephone companies in its directories, without regard to any obligations that may require such inclusion?

A. Yes. Directory customers receive more "value" for their paid advertising in a more comprehensive directory that includes all relevant listings within a market area and that is distributed to more customers. Thus, it is simply good business to publish the most complete possible directories and in doing so Dex management is simply doing its job.

Q. Has Dex absorbed any added costs or risks in order to publish secondary directories or to include non-Qwest listings in its directories?

A. No. All of the costs of Dex's publishing operations have historically been included in calculating imputation. When imputation was last calculated at $30.1 million in Utah, the Company did not remove or request the removal of revenues and income associated with Utah secondary directories or non-Qwest listings.[32] At that time, the Company was publishing both the South Valley Area Directory and the Wasatch Front On-the-Go directories and also included numerous non-Qwest listings in its directories. Therefore, Dex has not absorbed any additional costs or assumed any uncompensated risks by producing secondary directories or more complete primary directories that contain the customer listings of QC, CLECs and ILECs that provide telephone services within Dex directory market areas.

Q. What is the overall impact upon the Dex sale gain of the Company's proposed carve-out allocations to secondary directories and non-Qwest listings within primary directories published by Dex?

A. At line 12 of Confidential Exhibit CCS-1, the cumulative difference in allocations indicates that Qwest's new proposals regarding secondary directories and non-Qwest listings would improperly remove approximately (START CONFIDENTIAL) (END CONFIDENTIAL) of the Dex sale gain for retention by shareholders. Across the 14-state QC service territory, this treatment would reduce the gain potentially attributable to customers by more than (START CONFIDENTIAL) (END CONFIDENTIAL) on a post-tax basis.

Q. Have shareholders been exposed to operating losses since 1996 (when imputation was last calculated in Utah) as a result of Dex efforts to expand publishing of secondary directories or from the inclusion of additional non-Qwest listings?

32 Qwest response to Data Request CCS 2-13S1.

A. (START CONFIDENTIAL)
(END CONFIDENTIAL) since imputation was last determined in Utah at the $30.1 million annual level.

Q. Why is the Utah percentage allocation proposed by the Committee at line 15 of Confidential Exhibit CCS-1 so much lower than the percentage proposed by Qwest in its response to Data Request CCS 1-14S1?

A. The Company's proposed Utah allocation percentage is based upon the ratio of Utah directory revenues to total Dex directory revenues, excluding secondary directories and non-Qwest listings. However, since the Committee opposes Qwest's exclusion of secondary directories and non-Qwest listings within primary directories, the Utah allocation percentage must be recalculated to maintain consistency using revenues from all directories. A disproportionately higher share of Dex secondary directory revenues are earned in states other than Utah, so the Committee's inclusion of secondary directory revenues in calculating the allocation factor tends to reduce the Utah share of overall Dex revenues. If the Commission agrees with the Company's proposed carve out of secondary directories and non-Qwest listings, the higher Utah percentage calculated by Qwest and shown in column B should be employed to maintain consistency.

Q. What is shown at line 16 of Confidential Exhibit CCS-1?

A. Line 16 shows the Utah share of the anticipated Qwest Dex after-tax gain on sale, under the Company's allocation approach in column B, and as proposed by the Committee in column C. Because these amounts are net of accrued income taxes (from line 5) it is necessary to factor-up to a pretax equivalent value for comparison to imputation revenues. This factor-up appears at lines 17 and 18.

Q. Is the amount shown at line 18 the total Dex gain on sale amount properly attributed to the Utah jurisdiction?

A. Yes. This is the amount available, pursuant to the negotiated terms of the Dex sale transaction and after the allocations just described, to fund continuing imputation and other forms of benefit to Utah customers.

Q. At lines 19 through 21, you show the amounts of imputation ordered by the Commission in the last Utah rate case on a post-tax and pretax basis. Do these amounts represent an ongoing customer benefit that is embedded within current rates and revenues and that relates to the Dex business being sold?

A. Yes. Under traditional regulation, the sale of Dex could result in the removal of imputation in the Company's "next" rate case, because the directory affiliate and its income stream would no longer be available for Commission consideration. In addition, financial information needed to calculate a current imputation level would no longer be in the possession of Qwest after the business is sold.

Q. Under price cap regulation, is there any known vehicle for removal or adjustment of the embedded imputation amount?

A. The only tool available to the Commission that I am aware would be to either remove or revise the amount of imputation through use of the Exogenous Factor "Z" pursuant to R746-352-4C.

Q. Has the Company proposed the ultimate removal or adjustment of the embedded imputation amount?

A. It is difficult to tell. According to Company witness Scholl, "QC is not asking to increase its rates at this time based upon the Dex sale."[33] Unfortunately, Qwest offers no assurances beyond "at this time" and later at page 36 Ms. Scholl states her opinion that, "…directory imputation should not remain in place indefinitely." The Company's testimony proposes no conditions be imposed upon the sale of Dex and provides no proposal for the final resolution of directory imputation issues. Thus, the Company's proposed sale of Dex with no regulatory conditions creates a regulatory risk that Qwest may seek removal of imputation as a future exogenous change.

Q. Does the pending sale of Dex provide an opportunity to resolve directory imputation issues with some finality?

A. Yes. The sale of Dex provides a liquidating gain on sale value for the directory publishing business as well as an extraordinarily large cash payment for consideration by regulators. In my opinion, the Utah customers of QC are entitled to the pretax value shown at line 18 of Confidential Exhibit CCS-1 as of the date of closing the Rodney transaction. Fortunately, the extraordinarily large cash value for Dex that is being realized in the sale, in spite of the lower sale price caused by QCI's financial predicament, is sufficient to fund: 1) continued customer credits equal to embedded imputation for many future years, and; 2) a substantial immediate credit to customers to mitigate the risks arising from the transaction.

Q. Referring to Confidential Exhibit CCS-1, how did you calculate the funding required to maintain annual credits to Utah customers equal to the $30.1 million per year in place of embedded imputation?

33 Direct Testimony of Laura Scholl, page 13.

A. At lines 32 through 34, I have calculated the present value of an annuity in the annual amount of $30.1 million over a range of future periods from 15 years to as many as 50 years. The discount rate used in this calculation is the 9.76 percent overall rate of return found reasonable by the Commission in USWC Docket No. 97-049-08. The "cost" in today's dollars to advance fund a $30.1 million per year customer credit to secure embedded imputation ranges from $255 to $335 million based upon a 15 versus 50 year term. I recommend that the Utah share of the gain be attributed first to the funding of long-term rate stability. Stated differently, I propose that the first (START CONFIDENTIAL) (END CONFIDENTIAL) of the Utah share be "spent" on a firm commitment to credit $30.1 million a year to customers over the next 30 years and thereby provide long-term protection against exogenous rate increases to remove embedded imputation.

Q. Why did you elect to use the 30-year period for continued credits in lieu of imputation, rather than some other period?

A. It is difficult to predict how telecommunications services may be provided or regulated in the distant future. It is probable that continuing public policy initiatives and technological changes will eventually succeed at substituting competition for regulation of such services within the next 15 years. However, in an abundance of caution, I elected to secure customer credits for twice that long, recognizing that exogenous factor rate increases to remove imputation after year 30 are unlikely to ever occur if competition ultimately replaces regulation. It should be noted that, because of the discounting factor employed, adding more years of credits beyond year 30 does not substantially change the present value funding required today.

Q. In addition to the $30.1 million annual credit for the next 30 years, is there is a residual amount available for a one-time crediting to Utah ratepayers?

A. Yes.

Q. What amount of one-time credit to Utah ratepayers should be ordered as a condition of Dex sale approval in this Docket, after securing the embedded amount of imputation?

A. Lines 36 through 38 of Confidential Exhibit CCS-1 reflect the residual amount of the Utah share of the Dex gain, after subtracting the present value of the credit annuity shown at lines 32 through 34. Thus, selection of the 30-year funding period to secure imputation results in a residual value to be credited to Utah customers on a one-time basis in the amount of $90.8 million. I recommend this amount be credited to Utah customers, either as a one-time bill credit or as an exogenous price cap adjustment imposed after the Rodney transaction is closed.

Q. Why is a one-time credit to QC Utah customers for the residual Dex sale Utah gain amount appropriate?

A. As established in prior Commission Orders and explained in my earlier testimony, the Dex directory publishing business represents a regulatory utility asset and the sale of that asset is an extraordinary event that yields a gain to be attributed to customers. The Utah share of this gain should first be used to avoid future rate changes to remove embedded imputation, with the residual gain above this amount flowed to customers. I am advised by Counsel that the Commission may find it appropriate to credit this residual value directly to customers through bill credits or, alternatively, could treat this residual value as an exogenous price cap adjustment. The sale of Dex and resulting gain on sale and loss of directory income is an “extraordinary event not reasonably foreseeable as of April 30, 1997, within the meaning of R746-352-4C(1)(f). The financial impact of the Dex gain on sale would not otherwise be captured in general measures of inflation or productivity, or be influenced by costs or revenues incorporated into the inflation measure or productivity factor, because the Dex sale and gain is an extraordinary one-time event.

Q. Is the percentage of Dex proceeds that you propose be credited to customers on a one-time basis a relatively minor amount of the overall anticipated Dex gain on sale?

A. Yes. The $90.8 million Utah one-time credit represents only about 1.3 percent of total Dex sale proceeds.

Q. How does your proposed overall Utah gain allocation, consisting of a 30-year credit to secure embedded imputation and a residual one-time customer credit to customers, compare with your testimony on this subject in the last Utah rate case?

A. In the last Utah rate case, I testified that a credit of $283 million in Utah would be reasonable on a one-time basis if imputation was to be permanently and completely eliminated, as advocated by the Company in Docket No. 97-049-08. That amount was based upon the present value of a $30 million ongoing imputation over the next 30 years, utilizing a 10 percent discount rate. The comparable value in Confidential Exhibit CCS-1 at the 9.75 percent discount rate now being employed is (START CONFIDENTIAL) (END CONFIDENTIAL). I also testified in Docket 97-049-08 that the $283 million one-time credit amount was very conservative in that it assumed no growth in future imputation amounts, contrary to the consistent growth in USWD revenues and excess earnings that had actually been experienced historically.

Q. How is it possible to secure continued imputation for 30 years and also credit customers $90.8 million on a one-time basis out of the realized gain from the sale of Dex?

A. Since the 1996 test year in which imputation was set at $30.1 million, there has been considerable growth in the directory publishing business. Historical Dex revenue and profit growth, as well as the prospects for continuing Dex growth, have driven the value of the business to more than $7 billion, even in a distressed sale environment.

Q. Should the Commission be discouraged from imposing a one-time $90.8 million customer credit in Utah because the amount represents a large percentage of annual revenues earned by QC in the State?

A. No. QCI will realize the large gain from the sale of Dex within its income statement, but will not be recording a reasonable share of this gain within the Utah QC income statement. If the Utah share of the Dex gain were credited into the Utah books, the gain would more than offset an accounting accrual for the $90.8 million customer credit being proposed by the Committee. The residual customer credit proposed by the Committee should be thought of as funded by the parent entity that is realizing the large gain on sale associated with liquidation of Dex.

Q. Will the imposition of a $90.8 million one-time customer credit in Utah, combined with reasonably expected regulatory impacts from the Arizona and the Washington Commissions, where the Dex sale transaction is also under consideration, cause QCI to fail in its efforts to de-lever its balance sheet and improve its credit ratings?

A. It is difficult to predict regulatory outcomes in Arizona and Washington that may involve customer credits from the Dex gain on sale, but if one assumes a regulatory response in those states that is proportionate to my recommendation in Utah, the vast majority of the Dex gain on sale and cash proceeds will be retained for shareholders and will be available to the Company to reduce outstanding debt.[34] The parties to the transaction envisioned and provided for an acceptable level of regulatory retention or giveback to customers from the Dex gain and the proposed Utah customer credit requires less than (START CONFIDENTIAL) (END CONFIDENTIAL) of the MRI allowance. However, even if the MRI threshold were exceeded, it is important that ratepayers' interests in Dex and the gain on sale not be compromised in an effort to provide incremental cash flow to support Qwest's debts that were incurred largely to grow its unprofitable non-regulated businesses. These debts may ultimately prove to be insurmountable problems if the health of the non-regulated businesses fails to dramatically improve.

Q. If the Commission determines that concerns about QC service quality or service availability dictate dedication of some of the $90.8 million one-time customer credit to specific programs or incremental investments, what should be done to ensure that customers' interests in this portion of Dex gain value are secured?

A. Any amounts dedicated to new service quality or network investment programs should be carefully defined and budgeted so that regulatory reporting and monitoring can be implemented to track costs and reconcile program results against planned activity and expenditure levels. At the inception of any ordered programs, the portion of the Utah

34 In the Company's highly confidential financial projections provided in response to Data Request CCS 1-61, the Rodney proceeds were (START CONFIDENTIAL)

(END CONFIDENTIAL). Paragraph 2.5 of the Rodney Agreement that provides for the payment of up to $300 million of the purchase price at closing by Buyer tendering "Buyer Securities" in lieu of cash. Even with these (START CONFIDENTIAL)

(END CONFIDENTIAL), the period displayed in Mr. Johnson's table of debt maturities at page 22 of his testimony. Since these projections were prepared, QCI finalized a private debt exchange transaction that further reduced its total indebtedness and extended some of the near-term maturities to improve corporate liquidity.

Dex sale gain made available for funding should be recorded in a regulatory liability account that is then used to track program expenses and transferred to offset new plant investment "contributed" by customers, rather than QC investors. I have not developed any specific new service quality or network investment proposals for consideration by the Commission, but recognize that application of Dex sale gain benefits to such programs may be desirable. Use of the regulatory liability accounting I recommend will "reserve" such monies to accommodate additional more detailed study of program specifics in the future.

Rebuttal to Qwest Witnesses

Q. At pages 9 through 12 of her testimony, Ms. Scholl describes QC's directory publishing obligations under the Federal Telecommunications Act of 1996 and the Utah Commission's rules and explains how these specific obligations are met under the current and proposed directory publishing agreements. Has the existing affiliate publishing agreement between QC and Qwest Dex ever been found by the Commission to be reasonable in the way it compensates QC for the official publishing rights transferred to Dex?

A. No. The current and prior affiliate publishing agreements made effective between the directory publisher and the affiliate regulated telephone company have been consistently rejected and restated by the Commission via ratemaking imputation adjustments, because these agreements failed to fairly compensate the telephone company for the extraordinary value associated with the exclusive right granted the affiliate to publish QC's official directories. The new Publishing Agreement with the Buyer of Dex also provides no compensation to the telephone company for the valuable ILEC official publishing rights. The negotiated $7.05 billion price for Dex is largely reflective of this valuable official publishing right that is being purchased from QCI for cash and then being secured by a long-term non-competition agreement that prevents the ILEC from re-entering the directory business and eroding this value.

Q. At page 13 of her testimony, Ms. Scholl states, “QC believes that this flow of subsidy from directory operations to its basic regulated local exchange services has no place in an environment where public policy encourages entrants to compete to supply those services. Moreover, if there ever were any financial obligation under which directory revenues should have been used to support local exchange prices, that obligation has long since been satisfied by nearly twenty years of contribution.” Do you agree with the characterization of directory imputation as a subsidy or the notion that Qwest’s imputation “obligation” has been satisfied because it has lasted nearly 20 years?

A. No. The production of telephone directories and the sale of advertising in such directories has been a profitable by-product of the local exchange telephone business for many decades. Directory imputation only became necessary in Utah because of the transfer by U S West of the publishing affiliate effective in 1984 and the corresponding implementation of unreasonable affiliate publishing agreements effective since that time. Imputation is not a “contribution” or a “subsidy” and has been required for almost 20 years in Utah. Imputation was required simply because unreasonable publishing agreements that removed directory profits from the telephone company’s books have been effective for this period of time. The new Publishing Agreement with the Buyer of Dex does not remedy this long-standing problem because QCI is selling the official publisher designation and related non-competition covenants for cash proceeds, while fair compensation is again denied the telephone company and its customers.

Q. At page 14, Ms. Scholl states, "Directory operations were thus begun in a competitive environment…Regulatory commissions have not historically, and still do not, exercise oversight or control over the advertising business in the White or Yellow Pages or of the operations, accounts, employees, expenses, investment or revenues of the directory publishing operations. In addition, there have always been alternative providers of directories not affiliated with local exchange companies." Do any of these arguments justify attributing the profits earned by the directory business or the entire gain on sale of the business to shareholders rather than Utah customers?

A. No. Despite Ms. Scholl's efforts to distance the directory business and the gain on sale of Dex from the Commission's jurisdiction, there is no denying that the directory business has been an integral part of the telephone business until it was transferred into an affiliate without Commission approval effective in 1984. The Commission has consistently exercised its jurisdiction over the directory publishing business. This exercise of jurisdiction included consideration of directory revenues, expenses and investment that were embedded in telephone company accounts until 1984.

After 1984, Commission jurisdiction over directory publishing was exercised by explicitly recognizing White and Yellow Pages operations, accounts, employees, expenses, investment and revenues on the books of the directory publishing operation in calculating imputation adjustments. When directory costs or invested capital increased, the result was reduced imputation. Fortunately, directory revenue growth consistently exceeded directory publishing costs and invested capital, such that imputation values tended to grow.

The existence of alternative suppliers of directories has not served to convince the Commission that imputation should be discontinued in prior cases. There have been competitive publishers for many years in Utah and other states, but they have had little success in reducing the revenues or profits of the incumbent local exchange affiliated publisher. Indeed, competitive pressures upon Dex have been directly reflected in the revenues and earnings of Dex that have served as the basis for imputation calculations.

Q. If directory publishing predated state regulation in Utah, as referenced by Ms. Scholl at page 15, do you agree with the statement at page 16 that, "Consequently QC's predecessors' investors bore all of the risk of starting and developing the directory publishing business"?

A. No. The Company has made no showing that any significant costs or losses were borne by shareholders at the inception of directory publishing in Utah. In fact, in its response to Data Request CCS 2-31, the Company stated, "Qwest does not have any information that directory operations ever incurred losses, although it is conceivable that they did in the earliest years of operation (as most start up enterprises do). However, Qwest understands that directory operations have always been profitable during the years since Qwest Corporation and its predecessors were subject to regulation."

Q. Would it be a high risk and high cost endeavor to add advertising into an existing telephone directory or to commence the printing and distribution of directories containing paid advertising?

A. No. The directory publishing business does not rely upon large tangible asset investments, but is instead dependent mostly upon intangible assets and human resources. The discretionary nature of selling and publishing directory advertising and the minimal incremental capital investment required to enter the directory business makes it highly unlikely that any significant costs or losses would be involved in adding advertising products to printed directories. Absent any regulatory requirement to publish directories at a loss, prudent early telephone company management would have accepted only advertising that could be profitably included within directories.

Notably, Ms. Scholl offers no financial analysis to support her opinion at page 16 that significant risks were incurred by investors to develop directories prior to regulation, or the opinion that at the time regulation was "introduced", the directory business "…was already a profitable line of business."

Q. Also at page 16, Ms. Scholl asserts that "customers paid for telephone service at just and reasonable levels that did not include their providing any financial contribution to the directory business." Is this true?

A. No financial "contribution" to the directory business has been shown to be required from customers <u>or from shareholders</u>. Ms. Scholl implies that shareholders have made significant financial investments or "contributions" to the directory business and are therefore entitled to most or all of the gain upon sale of the business. As noted above, the directory business is not capital intensive and probably required little "financial contribution" from anyone whenever it was actually established. We should also remain mindful of the distinction to be made between directory publishing and directory paid advertising that offsets the costs of producing phone books. Production and distribution of alphabetical and classified directories adds value and function to telephone service and has historically been considered part of the telephone business at any reasonable cost. The incremental addition of paid advertising to the directory publishing activities of the telephone company was therefore a profitable business decision at inception that has been more than self supporting ever since.

Q. Does the linkage between alphabetical and classified directories and telephone service that you describe throughout your testimony predate the creation of the Utah Commission, as referenced at page 16 of Ms. Scholl's testimony?

A. Yes. Telephone directories were of little value without telephone service and the value of telephone service was enhanced by published directories throughout the distant history addressed by Ms. Scholl. This is why the early telephone companies came to be the initial and ultimately the dominant publishers of directories. The directory publishing operation has consistently been operated as part of the telephone company throughout history, until the publishing function was moved into an affiliate in 1984. The directories published by Dex today have been developed and augmented over many years while such directories were produced by the regulated telephone company and also while such directories were produced by the affiliate, subject to imputation by the Commission.

Q. What is the relevance of the accounting classifications associated with directory revenues and expenses, as mentioned at page 17 of Ms. Scholl's testimony?

A. The fact that the FCC Uniform System of Accounts specified the accounts to be used for directory publishing by telephone carriers is a clear indication of the linkage of publishing activities to telephone services. Ms. Scholl fails to mention that all of the Part 31 and Part 32 accounts referenced in her footnote 9 are above the line accounts that are routinely included within calculations of telephone company operating income and in calculating jurisdictional revenue requirements.

Q. Does it matter that, "The FCC considers Yellow Pages publishing a separate, unregulated line of business", as noted by Ms. Scholl at page 17?

A. No. Directory publishing is an intrastate business function that has never been attributed to the interstate jurisdiction for ratemaking purposes. Therefore, FCC treatment as "a separate, unregulated line of business" has never precluded state regulators in Utah from including directory profits or imputation (since 1984) in determining intrastate jurisdictional revenue requirements.

Q. Is Ms. Scholl's statement, "The Commission has never reviewed the prudence of investments or expenses of the directory operations" completely accurate?

A. I am not aware of any formal investigation of directory prudence that has been conducted or ordered by the Commission, but I know that directory investments, expenses and operations were necessarily scrutinized in determining the proper level of imputation in prior rate case proceedings. In my own analysis of directory operations prior to sponsoring imputation adjustments, I routinely investigated investment and expense levels of the directory affiliate, particularly with regard to parent and affiliate company charges embedded therein.

Q. At page 18 of her testimony, Ms. Scholl states, "Ratepayers of regulated telephone service have never borne the economic burden of the directory publishing business. During the entire period that Mountain Bell engaged in directory publishing, the costs of directory publishing were being fully covered by revenues from sales of advertising." Does this claim indicate that shareholders are entitled to the gain on sale of Dex?

A. No. The second sentence of this statement is an admission that there is no economic "burden" associated with directory publishing, but instead a consistent economic benefit from these activities. Taken with her statement at page 16 that by 1917, directory publishing in Utah, "…was already a profitable line of business", there is no basis to claim that a burden was borne by either shareholder or customers after 1917. Nor is there any evidence of an economic burden before 1917.

Q. Do you agree with Ms. Scholl's claim at page 18 that customers never incurred any risk of loss associated with the directory publishing business?

A. No. Telephone service customers have paid rates that were directly impacted by the financial performance of the directory publishing business for many years. It is not necessary for customers to be investors in the business, for there to be attribution of risks to them. For the entire period when directory publishing was included within the telephone company's operations, any cost-based regulation that occurred would automatically include all increases in directory expenses and investment, as well as any declines in directory revenues, within the established revenue requirement. For the subsequent "imputation" period starting in 1984, increases in directory expenses or investment as well as declines in directory revenues that might have occurred had the direct effect of reducing the imputation adjustment.[35] Ms. Scholl implies at pages 18 through 22 of her testimony that directory operations have entailed significant risks, losses and speculative investments that were not supported by customers, yet she has not identified or quantified any risks, investments or losses from directory publishing that have <u>ever</u> been absorbed by shareholders.

Q. At page 21 of her testimony, Ms. Scholl claims, "The going concern value of the directory business that made those profits possible, however, was never included in Mountain Bell's rate base. Hence, the ratepayers received the benefits without paying rates that included a return on or a return of the going concern value of the business that

35 It is conceivable that regulatory disallowances of directory expenses, investment or revenue declines may have been ordered, either during the period when directory operations were within the telephone company, or as part of the imputation calculations. However, the Company has not identified any prudence disallowances imposed by the Commission in prior rate cases to force shareholders to bear the risk of loss described in Ms. Scholl's testimony.

produced those profits. The benefit of the business (its profit making ability) was transferred to ratepayers without any compensation to the investors that bore all the risk of starting and developing that business". How do you respond to that claim?

A. It was never necessary or appropriate for Mountain Bell's rate base to be increased because of directory business going concern value. There are several reasons why "going concern value" for directory publishing was not includable in telephone company rate base:

- No costs were incurred by the Company or its shareholders to establish this goodwill or "going concern" asset, it arose from the telephone company's unique opportunity to publish the directory listings of its subscribers within its official telephone directories and also include in the phone books advertising that was commercially valuable. Thus, directory going concern value was realized at no cost or risk to shareholders.

- The "goodwill" publishing business asset arose from telephone service incumbency, it would have been impossible to convince regulators that telephone customers should pay for a return on or return of such an asset.

- Accounting conventions in the United States are premised upon actual costs, rather than theoretical values. Any effort to include a goodwill asset for directory operations in 1917 or at any other date, with no underlying transaction to support such a valuation, would violate these conventions.

- Rate of return regulation in Utah and most other states is based upon actual rate base investment valued at original cost, rather than including the "fair value" of assets in rate base.

However, none of these reasons for excluding intangible goodwill assets in determining rate base supports Ms. Scholl's conclusion that anything of value "was transferred to ratepayers without any compensation to the investors" or that investors, "bore all the risk of starting and developing that business". Investors have not been required to finance any goodwill investment nor have they ever paid fair value for the intangible assets being referenced by Ms. Scholl. Consequently, investors are not entitled to any "compensation" when such assets are rightfully attributed to telephone customers.

Q. Upon review of imputation decisions of state regulatory commissions, have any courts held that ratepayers have a compensatory interest in the directory business?

A. Yes. Ms. Scholl cites the Utah Supreme Court's Opinion upholding imputation at page 34 of her testimony. The Utah Supreme Court's Opinion found the Dex directory assets to be public utility assets. The Utah Supreme Court cited similar findings by the Washington Supreme Court and the Colorado Supreme Court that the Company did not develop the lucrative Dex directory publishing business outside of the telephone company as a private enterprise by its initiative, skill, investment or risk-taking in a competitive market.[36]

Q. If directories with advertising were first published in Utah prior to state regulation of the telephone company, does it follow that the Dex business now worth more than $7 billion was developed outside of regulation?

A. No. The business now being sold for more than $7 billion was not fully developed prior to 1917, when the Commission was initially established. The current value of the Dex business has grown steadily over many decades, with most of the value created recently and under state regulation. For example, in testimony sponsored by the Company in Washington Docket No. UT-980948, a valuation witness for U S West testified that the value of the Dex business enterprise as of January 1984 was within a range of $1.5 billion to $1.8 billion when the business was first transferred into the publishing affiliate.[37] This valuation estimate as of 1984 implies that the Dex business has grown in value by about a factor of four in the past 19 years alone. Assuming consistent growth in the directory activities of Mountain Bell in the 67 years of state regulation from 1917 to 1984, virtually all of the current value of the Dex business was created after 1917.

Q. At page 27 of her testimony, Ms. Scholl references an internal transfer of the directory publishing business that occurred in 1996, at a business valuation for Dex of approximately $4.8 billion. How is this event and valuation for Dex relevant in the pending Dex transfer Docket?

A. This event and the corresponding valuation estimate was mentioned in my testimony in the last rate case. After concluding in its Order in Docket No. 97-049-08 that the pre-1984 directory operations met the Wexpro I criteria to be considered utility assets, the Commission stated at page 30:

> The directory operations imputation approach used by the Commission meets the goal of the Wexpro I decision by keeping customers in the same position as they were prior to the transfer. It maintains the equivalent of the 'appropriate benefit' they enjoyed in the pre-1984 years.
>
> Because of this treatment, we have never been requested to make a one-time adjustment or needed to determine the fair market value of the directory operations. We could do so in this case due to the fortuitous existence of current market value studies of the directories operations for a transfer from the Media Group side of the US West, Inc., corporate holdings to the U S West Communications Group side. We believe the fair market value to be established in the *Wexpro I* context would not be different from the fair market value that is established in meeting the corporations's fiduciary duty to stockholders in the holding company inter-corporate transfer context. Evidence was introduced that

36 U S West Communications, Inc. v. Public Service Commission, 2000 UT 1 paragraphs 16, 17.

37 Direct Testimony of Timothy Golden dated October 16, 1998 in WUTC Docket No. UT-980948, page 4.

> the Utah allocated portion of this estimate of the directory operations' fair market value is $307 million. While there is record evidence of the fair market value, the parties have presented laminated evidence or testimony useful to determine a one-time appropriate benefit to apply for ratepayers in the *Wexpro I* context or that it would be in the public interest….
>
> Only the Committee provides any evidence that could be used as a basis for a one-time adjustment with no future imputation of directory operations. However, the Committee's market value evidence was presented as a check on the Committee's discounted, net present value calculation of continuing the directory imputation treatment based upon the 1996 test year's results for a period of thirty years. The Committee's calculation is presented solely to counter USWC's ostensible position of a one-time adjustment of $0. The Committee does not advocate a one-time adjustment. With the record developed for us, we decline to replace our past treatment of directory operations with a one-time adjustment in this rate case. Continuation of the directory operations imputation achieves the end that is dictated by *Wexpro I.*

Because the Commission retained the imputation remedy and did not adopt a large one-time customer credit in lieu of imputation, ratepayers continued to participate in the financial results of the directory publishing business while the business remained under U S West/Qwest control. Continuation of imputation caused the 1996 internal reorganization to be of no consequence to the regulatory treatment of Dex.

Q. At page 28 and 29 of her testimony, Ms. Scholl argues that, "Since the directory business was transferred to USWD in 1984, it has operated without investment of any funds or management of QC and its predecessors. The investments, expenses and revenues of the business have not been included in the regulated company's books" and that, "imputation is not the same as actually including investments and expenses in utility accounts." Is this true?

A. No. Imputation has the same effect as including directory investments, expenses and revenues within above-the-line accounts for ratemaking purposes. Ms. Scholl is trying to draw fine distinctions that have no economic reality. While the directory publishing business was moved into and operated within a separate corporate entity, it was never effectively removed from the Commission's jurisdiction because imputation directly recognized all of the investments, expenses, revenues and results of management actions that impacted directory operations. The economic reality of imputation is that it results in the same outcome as actually including directory investments and expenses in utility accounts. This result was referred to in the Commission's order cited above which stated, "The directory operations imputation approach used by the Commission meets the goal of the *Wexpro I* decision by keeping customers in the same position as they were prior to the transfer. It maintains the equivalent of the 'appropriate benefit' they enjoyed in the pre-1984 years". (emphasis added)

Q. At pages 3 and 6 of his testimony, Qwest witness Mr. Burnett refers to efforts made to expand and improve the directory publishing business that have been made since the 1984 transfer outside the telephone company. Do these enhancements or the additional revenue they produce justify attributing a portion of the value of the gain on sale of Dex to shareholders, rather than QC customers?

A. No. Changes made to printed directories, such as the improvement of fonts, inclusion of color maps, community information pages, colored advertising and white pages enhancements should not be attributed to shareholders at all, because such improvements are simply the result of prudent business management and did not entail any significant startup costs or risks to shareholders. In calculating imputation adjustments in Utah, all of the expenses of Dex management and non-management labor, benefits, materials and contractors were included and reduced imputation amounts. I explained in earlier testimony why Dex earnings associated with secondary directories and non-Qwest listings in primary directories should not be attributed to shareholders.

Q. In calculating imputation adjustments, has the Commission disallowed any Dex expenses associated with the development of new products, such as those listed in Exhibit GAB-2 that is sponsored by Mr. Burnett?

A. Not to my knowledge. There were no disallowed Dex expenses for product development in the imputation adjustment I calculated and sponsored in the last Utah rate case.

Q. Mr. Burnett describes the relationship between Dex and QC at page 3 of his direct testimony, stating, "All the tangible and intangible assets, intellectual property, human resources and operational know-how for directory operations were transferred to the new entity." Was any compensation provided to the telephone company or its customers when all of these assets were "transferred to the new entity"?

A. No. The telephone company received compensation for only some cash and certain tangible assets that were transferred at the formation of U S West Direct, as referenced at the bottom of page 24 of Ms. Scholl's testimony. There was no compensation for the fair market value of the directory publishing business paid to the telephone company or its customers in 1984 as no true sale of the business occurred on that date. The Commission did not approve the transfer that occurred in 1984 and has treated the directory publishing business as a regulatory utility asset with the Utah portion of Dex revenues, expenses and investment recognized in calculation of imputation adjustments since that date.

Q. At page 4 of his Direct Testimony, Mr. Burnett discusses the existing Publishing Agreement between Dex and QC that designates Dex as the "official publisher" for QC. Then at page 5 he states, "QC does not pay Dex for the services that Dex performs, nor does Dex pay QC under the Publishing Agreement for the right to be QC's official publisher." Has the Commission ever accepted this arrangement for purposes of regulation in Utah?

A. No. Imputation adjustments have been required in Utah in rate cases since 1984 because of the inadequate compensation received by the telephone company under the affiliate Publishing Agreement. The new Publishing Agreement with the Buyer of Dex will perpetuate this arrangement, where no compensation is provided to the telephone company for the "official publisher" designation or for the many other beneficial linkages to the telephone company that are provided. These benefits under the Publishing Agreement and other commercial agreements are secured by the new Non-competition agreement in favor of the Buyer represent a large part of what is being purchased for $7.05 billion.

Conclusion

Q. In your opinion, based upon the evidence sponsored by Qwest witnesses in this Docket and the work you have done to evaluate the proposed Dex sale transaction, should the Commission approve the sale of Dex?

A. The proposed Dex sale is vital to the efforts of Qwest to improve liquidity and maintain access to capital on reasonable terms. Therefore, the Dex sale should be approved by the Commission, but only if QC customers in Utah are afforded adequate and equitable participation in the financial benefits of the transaction and protection against the risks associated with the transaction. The Utah share of the Dex sale gain should first be dedicated to continuation of imputation at the $30.1million level that is embedded within present rates. The remaining Utah share of the gain calculated on Confidential Exhibit CCS-1, after accounting for continuation of embedded imputation, should be treated as an extraordinary credit to customers on a one-time basis, or at the discretion of the Commission, directed toward customer-funded service quality or network investment initiatives with rigorous regulatory oversight and accounting controls. With these conditions, approval of the proposed Rodney transaction can be found to be consistent with the public interest.

Q. Does this conclude your testimony at this time?

A. Yes.